

IN THE SUPREME COURT
STATE OF MISSOURI

WESTERN BLUE PRINT CO.,)
)
 Respondent,)
)
 v.) SC90172
)
DIRECTOR OF REVENUE,)
)
 Appellant.)

Appeal from the Administrative Hearing Commission of Missouri
Honorable John J. Kopp, Commissioner

BRIEF OF APPELLANT

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JURISDICTIONAL STATEMENT

This is a petition for review of a decision by the Administrative Hearing Commission, reversing the Director of Revenue's assessment of additional sales tax on Western Blue Print Co.¹ The petition was filed pursuant to Missouri Supreme Court Rule 100.02, and §§ 621.050 and 621.189, RSMo. 2000. This Court has exclusive jurisdiction over this matter, as it involves the construction of the revenue laws of this state. Mo. Const. Art. V, § 3.

¹ The AHC decision is found both in the Volume II administrative record, beginning at p. 477, and in the appendix. We cite herein to the appendix, "App."

STATEMENT OF FACTS

This is an appeal from a decision of the Administrative Hearing Commission (“AHC”) reversing the assessment by the appellant Director of Revenue of additional sales and use taxes from respondent Western Blue Print Co. (“Western”).

The activities at issue are carried out by Western’s “document automation development division.” App. 2. In its findings of fact, the AHC described those activities:

Western scans and images customer documents onto computer discs for distribution to its customers. The customer provides its documentation in paper form to Western, who then scans and images the documents on its own CDs [compact disks], which it then distributes to the customer. Western returns the original documents to the customer.

App. 2. In addition to “scan[ning] and imag[ing],” Western in some instances develops or acquires software to process images or to index data or documents. *Id.* And in some instances Western does not just scan and image documents, but also indexes them. *Id.* at 2-3.

In addition to producing the CDs it provides to customers, Western’s contracts typically require Western to retain a back-up set of CDs. *Id.* at 2.

Western charges a per-page price for each scanned item, plus an additional, separately-stated amount for each CD. *Id.*

Western does not pay sales tax on the CDs it purchases. *Id.* Nor does Western collect or remit to the Director sales tax on the amounts it receives from customers to whom Western provides CDs. *Id.*

This case arose from a 2006 audit of Western's sales and use tax payments. On November 14, 2006, the Director issued final decisions assessing Western \$41,414.29 in unpaid sales tax, plus interest, based on Western's estimated gross sales. *Id.* at 4. Western challenged the assessment in the AHC, which ruled in Western's favor on April 30, 2009.

POINTS RELIED ON

- I. The Administrative Hearing Commission erred in finding that Western Blue Print's sales of CDs were a nontaxable service rather than a taxable "sale at retail" because the CDs, which are tangible personal property, were the "true object" of the sales in that the CDs contained information already possessed by the customer and by contract the customers required that the information be placed on CDs rather than permitting transmittal in a form that does not involve tangible personal property.

Gammaitoni v. Director of Revenue,

786 S.W.2d 126 (Mo. banc 1990)

Universal Images v. Department of Revenue,

608 S.W.2d 417 (Mo. 1980)

§ 144.010.1

II. The Administrative Hearing Commission erred in finding that Western Blue Print's sales to its customers were exempt from taxation because those sales did not constitute sales of "computer output on microfilm or microfiche" under § 144.010.1(10) in that Western Blue Print sold compacts disks or CDs.

Cook Tractor Co., Inc. v. Director of Revenue,

187 S.W.3d 870 (Mo. banc 2006)

Middleton v. Missouri Dept. of Corrections,

278 S.W.3d 193 (Mo. banc 2009)

§ 144.010.1(10)

ARGUMENT

Legal Standards

This Court reviews the Administrative Hearing Commission's (AHC's) interpretation of the revenue laws *de novo*. *Missouri State USBC Ass'n v. Director of Revenue*, 250 S.W.3d 362, 363 (Mo. banc 2008). The Court upholds the AHC's factual determinations "if the law supports them, and, after reviewing the whole record, there is substantial evidence that supports them." *Id.*

As to facts, "[t]he taxpayer has the burden of proof before the AHC" *Hermann v. Director of Revenue*, 47 S.W.3d 362, 365 (Mo. banc 2001). *See* § 621.050.2 ("In any proceeding before the administrative hearing commission under this section the burden of proof shall be on the taxpayer").

The rules of construction used to interpret the revenue laws and their application to particular transactions varies according to the effect of that law. On the one hand, "[i]t is the Director of Revenue's burden to show a tax liability." *Cook Tractor Co., Inc. v. Director of Revenue*, 187 S.W.3d 870, 872 (Mo. banc 2006). On the other, "A taxpayer bears the burden of showing they are entitled to an exemption. Exemptions from taxation are to be strictly construed against the taxpayer, and any doubt is resolved in favor of application of the tax." *Branson Props. USA, L.P. v. Dir. of Revenue*, 110

S.W.3d 824, 825 (Mo. banc 2003) (footnotes omitted). Or put another way, “Exemptions from taxation are strictly construed against the taxpayer and, as such, it is the burden of the taxpayer claiming the exemption to show that it fits the statutory language exactly.” *Cook Tractor*, 187 S.W.3d at 872.

Both rules are implicated here.

POINT I

The Administrative Hearing Commission erred in finding that Western Blue Print’s sales of CDs were a nontaxable service rather than a taxable “sale at retail” because the CDs, which are tangible personal property, were the “true object” of the sales in that the CDs contained information already possessed by the customer and by contract the customers required that the information be placed on CDs rather than permitting transmittal in a form that does not involve tangible personal property.

I. Western Blue Print’s sale of CDs are not exempt from taxation as a nontaxable service by virtue of the “true object” test.

Missouri has “levied and imposed upon all sellers” a sales tax “for the privilege of engaging in the business of selling tangible personal property or rendering taxable service at retail in this state.” § 144.020.1. The tax is imposed “[u]pon every retail sale in this state of tangible personal property.” § 144.020.1(1). The sales tax law defines a “retail sale”– or a “sale at retail” –

as “any transfer made by any person engaged in business as defined herein of the ownership of, or title to, tangible personal property to the purchaser.”

§ 144.010.1(10).

The principal basis for the AHC decision was that Western’s transactions fell outside the scope of taxation, *i.e.*, that they were not “retail sales” or “sales at retail” because they were sales of services, not of tangible personal property.

There is no question, of course, that the CDs purchased from Western are “tangible personal property,” and that ownership of those CDs is transferred to the purchaser. But the AHC found that what the purchaser buys is not just the CD, but also nontaxable services. This Court has many times addressed instances where the purchase includes both taxable tangible property and nontaxable services.² In doing so, the Court has established the

² E.g., *Zip Mail Serv., Inc. v. Director of Revenue*, 16 S.W.3d 588 (Mo. banc 2000); *Gutknecht v. Director of Revenue*, 867 S.W.2d 709 (Mo. Ct. App. E.D. 1993); *Sneary v. Director of Revenue*, 865 S.W.2d 342 (Mo. banc 1993); *Bridge Data Co. v. Director of Revenue*, 794 S.W.2d 204 (Mo. banc 1990); *Travelhost of Ozark Mountain Country v. Director of Revenue*, 785 S.W.2d 541 (Mo. banc 1990); *K & A Litho Process, Inc. v. Director of Revenue*, 653 S.W.2d 195 (Mo. banc 1983); *James v. TRES Computer Systems, Inc.*, 642

“true object” test, *i.e.*, it has concluded that when the “true object” of a transaction is the purchase of a nontaxable service rather than tangible personal property, the transmission of tangible personal property incidental to the service will not make the transaction a “sale at retail.”³

The precedent most directly on point – albeit one that does not use the “true object” language – is *Gammaitoni v. Director of Revenue*, 786 S.W.2d 126 (Mo. banc 1990). Videotech, Gammaitoni’s company, did exactly what Western does: take information in the possession, ownership, or control of a customer, create an electronic record of it, place that record on electronic media (there, a videotape), and return the information in its original form plus the videotape to the customer for the customer’s use. To determine whether Videotech’s “sales of these original and duplicate videotapes ... were nontaxable services rather than sales at retail” (*id.* at 129), the Court looked at two precedents.

S.W.2d 347 (Mo. banc 1982); *Universal Images, Inc. v. Department of Revenue*, 608 S.W.2d 417 (Mo. banc 1980).

³ See J. Elaine Bialczak, Determining the Taxability of Sales Involving Services: the True Object Test,” 5 J. MULTISTATE TAX’N 244 (1996); 12 C.S.R. 10-103.600.

The Court first addressed *James v. TRES Computer Systems, Inc.*, 642 S.W.2d 347 (Mo. banc 1982). *TRES* involved the sale of “custom-made data and computer programming ... to a Missouri customer.” *Id.* at 347. The software was provided on magnetic tapes. *Id.* at 347-48. All agreed that the tapes were tangible personal property; the parties stipulated, for purposes of that case, that the data and programs were intangible personal property. *Id.* at 348. The question was how to deal with a sale when it included both tangible (the tapes) and intangible (the software and data) personal property. The Director argued that the software and data became part of the tangible personal property when they were placed on the tapes; the taxpayer argued that the transfer of the tapes was merely incidental to the sale of the intangible personal property. *Id.* at 348. The Court recognized that Chapter 144 did not “provide any guidance” as to the question. *Id.*

The Court looked for guidance in decisions in other states. It cited first “the ‘essence of the transaction test,’” where courts had determined “that the presence of the data on the tapes is merely an incidental physical commingling of the tangible tapes and the intangible information with is actually the subject of the transaction.” *Id.* at 348-49. And it described “a related test” in which “the court attempts to discover the intent of the parties.” *Id.* at 349. Restricting its decision to the particular facts before it, and expressly refusing “to formulate a fixed, general rule which later could

have unpredictable results” in the “rapidly developing” computer field, the Court held that the TRES transactions were nontaxable sales of intangible property for two reasons. *Id.* First, it concluded that “the tapes themselves were not the ultimate object of the sale,” *i.e.*, that the customers were seeking only “the data and programs” the tapes contained. *Id.* Second, it found that the tapes themselves were not necessary, *i.e.*, that the data and programs could have been provided to the customer by other means. *Id.*

The second case addressed in *Gammaitoni* was *Universal Images v. Department of Revenue*, 608 S.W.2d 417 (Mo. 1980), decided two years before *TRES*. *Universal Images* was a use tax case arising from the purchase and use of 35mm prints of promotional films made to advertise in movie theaters. The taxpayer claimed that it was “not ‘storing, using or consuming’ tangible personal property” in the state, asserting that the transactions were really for the nontaxable service of compiling and creating the film, rather than the tangible film itself. *Id.* at 420. The Court agreed that charges “for services by an out-of-state laboratory” in production of the films were not subject to tax, but otherwise upheld the Director’s assessment of “a use tax based on the cost of the film or prints, including services, other than charges incident to the extension of credit.” *Id.* at 420.

In *TRES*, the Court stated that it had held in *Universal* that “the motion picture film was taxable as tangible personal property at its

transaction value.” 642 S.W.2d at 350. The Court distinguished the film in *Universal* from the computer tapes in *TRES*, however, because the “movie film in *Universal Images* was purchased as a finished product with the idea that the tangible film itself would be used and reused,” whereas the computer tapes in *TRES* would not. *Id.*

The Court deemed the videotapes in *Gammaitoni* to be like the film in *Universal* and unlike the computer tapes in *TRES*. 786 S.W.2d at 129-30. The videotapes would be used by the purchaser to show Videotech’s portrayal of information, and not merely to transmit the portrayals to a device on which they would be stored. But the Court made an additional observation about the facts that brings *Gammaitoni* closer to the facts here. “Unlike the bank in [*TRES*], Videotech’s customers already possessed the information and ideas, which they presented to Videotech to be placed on the medium of videotape.” *Id.* That is precisely what Western does: take “information and ideas” that its customers possess on paper, and copy them onto a different medium. In essence, Western is taking pictures of its customer’s documents and returning those pictures to the customer.

Just as the customer in *Gammaitoni* could make duplicates of the videotapes and use those duplicates to show the portrayals created by Videotech, Western’s customers can duplicate the images on the CDs, onto other CDs, computer hard drives, paper, or elsewhere. But what Western’s

customer gets is even less a product of Western's work than were the videotapes in *Gammaitoni*.

Of course, today it may well be possible for Western to transmit via the Internet the digital files containing the images of its customers' documents, thus avoiding the use of tangible personal property altogether. But the contracts between Western and its customers preclude that approach, demonstrating that the CDs themselves have value to the customers – perhaps because they provide stable, long-term storage of the images. That conclusion is reinforced by the requirement in the contracts that Western itself maintain a backup set of CDs – precluding Western from merely storing the images on its own computer hard drives or those of a third-party Internet vendor.

Because Western and its customers have carefully and deliberately chosen to require the production, transmittal, and retention of the CDs – *i.e.*, of tangible personal property – the holding in *Gammaitoni* applies and transactions are taxable “sales at retail.”

POINT II

The Administrative Hearing Commission erred in finding that Western Blue Print's sales to its customers were exempt from taxation because those sales did not constitute sales of "computer output on microfilm or microfiche" under § 144.010.1(10) in that Western Blue Print sold compact disks or CDs.

II. Western Blue Print's sales of CDs are not exempt from taxation by virtue of the exemption for specified types of "computer output."

Western argued, and the AHC agreed, that even if it was selling tangible personal property rather than services, its sales are exempt under an exclusion contained in the definition of "sale at retail": "(ii) the selling of computer printouts, computer output or microfilm or microfiche and computer-assisted photo compositions to a purchaser to enable the purchaser to obtain for his or her own use the desired information contained in such computer printouts, computer output on microfilm or microfiche and computer-assisted photo compositions shall be considered as the sale of a service and not as the sale of tangible personal property." § 144.010.1(10). But Western is unable to meet its burden as to that exclusion, for the transactions at issue do not "fit[] the statutory language exactly." *Cook Tractor*, 187 S.W.3d at 872.

The exclusion covers “computer output.” But it does not cover all forms of “computer output,” only those specifically listed. So it was Western’s obligation to prove that its customers wanted and purchased “computer printouts, computer output on microfilm or microfiche[, or] computer-assisted photo compositions.” In fact, the CDs were none of those.

Standing alone, “computer output” could be a vague term. But history provides some context for how that term fit into the statute when it was added in 1976. In the early days of electronic computing, computers were not connected; transferring electronic signals from one computer to another required, first, that the signals be recorded in a machine-readable form, then that they be physically carried to another computer and loaded there. Some of those machine-readable forms may be essentially unknown to even those studying computer science today: punch cards and perforated paper tape. Magnetic tape is still in use, though largely for backing up systems for disaster recovery, rather than for transmitting signals to another machine. Movable “hard disk drives” still exist, but the drives of the 1970s, as large as a hatbox, have long-since been replaced with tiny ones. “Floppy disks” also became smaller, and increasingly rare.

The General Assembly did not, however, leave the term “computer output” to stand alone. Rather, it made the exclusion available only to output that came in specified forms. Those were forms that the recipient could use

without having a computer at all: printouts, microfilm or microfiche, and photo compositions. After all, that was before the “personal computer” became a common element of offices and homes. *See* THE NEW YORK TIMES GUIDE TO ESSENTIAL KNOWLEDGE, A DESK REFERENCE FOR THE CURIOUS MIND (2d Ed. 2007), at 448. Buying “computer output” that could only be viewed with use of another computer was, for most customers, pointless.

In more than 30 years, though computing technology has advanced dramatically, the General Assembly has not added to the list of forms of excluded “computer output.” It might make sense today to do so. After all, what Western does is now common, even on ubiquitous home computers: to record electronic data on a medium that is useless to someone without a computer. But when or whether to extend the language to exclude means of transmission from one machine to another – whether by modern CDs, DVDs, USB drives, or external hard drives, or by archaic magnetic or paper tape – is for the General Assembly, not the courts, to decide.

The AHC did not see a need to concern itself with the logic and language of the exclusion. It simply noted that the language enacted includes two almost-parallel phrases, and decided that the second, more limited one must be a clerical error. In the AHC’s view, to read and apply the second provision as written would lead to “an absurd result.” App. at 17. But the AHC does not identify what the result would be, much less describe the

absurdity. This Court, as the AHC explained (*id.*), has cited the language but never dealt with the differences in wording.

If the Court must conclude that there was a clerical error and choose between the version that uses “on” and the one that uses “or,” it should hold to the use of “on.” That is true not just because exemptions are narrowly construed, but because the version using “or,” if applied twice, makes much of the language of this particular exclusion superfluous. It eliminates from “sale at retail” all “computer output,” which would necessarily include computer-produced printouts, microfilm, microfiche, and photo compositions. This Court has recently reiterated:

When ascertaining the legislature’s intent in statutory language, it commonly is understood that each word, clause, sentence, and section of a statute should be given meaning. ... The corollary to this rule is that a court should not interpret a statute so as to render some phrases mere surplusage.

Middleton v. Missouri Dept. of Corrections, 278 S.W.3d 193, 196 (Mo. banc 2009) (citations omitted). To read the exclusion to cover all forms of “computer output” would make most of the exclusion language “surplusage.”

The AHC correctly observed that this Court has not endorsed the limitation of “computer output” that the Director finds here. But it has never

been asked to. Thus in *Zip Mail Services, Inc. v. Director of Revenue*, 16 S.W.3d 558, (Mo. banc 2000), this Court could blithely restate the language of § 144.010.1(10) as if it included all “computer output,” no matter what the form: “section 144.010.1(8) [now (10)] expressly excludes computer printouts and computer output from the sale of a product in section 144.030.2(5).” The limitation that matters here was simply not at issue in *Zip Mail*. Nor was it at issue in any of the other cases in which this Court cited § 144.010.1(10). See cases cited in note 2, *supra*. This Court’s descriptions of the statute in those cases are dicta, to the extent they suggest an answer here.

Equally important, the Court’s paraphrases of § 144.010.1(10) highlight the linguistic problem that the AHC holding creates: Again, if, as this Court broadly stated in *Zip Mail*, the statute exempted *all* “computer output,” then there was no need to also exempt particular, named forms of output, like printouts.

If the Court were to derive rules from cases where the scope of the exclusion in 144.010.1(10) was not at issue, it would have to consider not just those where it broadly paraphrased the statute, but also its rationale in *James v. TRES Computer Systems*. The tangible personal property in that case consisted of computer tapes, used to transmit programs and data from the vendor’s computers to those of the purchaser. 642 S.W.2d at 348. If the language of what is now § 144.010.1(10) excluded all “computer output,”

there would have been no need to address the “true object” of the transactions. But that was not enough, forcing the taxpayer and the Court to address the “true object” question.

The statute as written is simply not as broad as the AHC held, and as Western Blue Print wishes. Until the General Assembly acts, the exclusion does not and will not cover all “computer output,” but only output in the form of printouts, microfilm, microfiche, and photo compositions.

CONCLUSION

For the reasons stated above, the decision of the Administrative Hearing Commission should be overturned and the Director’s assessment upheld.

Respectfully submitted,

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CERTIFICATION OF COMPLIANCE

The undersigned hereby certifies that the foregoing brief complies with the limitations contained in Rule No. 84.06(b), and that the brief contains 3,818 words.

The undersigned further certifies that the labeled disk simultaneously filed with the hard copies of the brief has been scanned for viruses and is virus-free.

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APPENDIX

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